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Nos. 83-1234, 83-1248, 83-1250, and 83-1278 **FEB 28 1984**

**ALEXANDER C. STEVENS**  
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IN THE  
**Supreme Court of the United States**

OCTOBER TERM, 1983

ASHLAND OIL, INC., *et al.*,  
v. *Petitioners,*

FRANK GOOD, *et al.*,  
*Respondents.*

KEWANEE OIL COMPANY,  
v. *Petitioner,*

BARBARA HOLMES, *et al.*,  
*Respondents.*

On Petitions for Writs of Certiorari to the  
Supreme Court of the State of Kansas

**BRIEF AMICI CURIAE OF AMERICAN PETROLEUM  
INSTITUTE, KANSAS INDEPENDENT OIL AND GAS  
ASSOCIATION, MID-CONTINENT OIL AND GAS  
ASSOCIATION, ROCKY MOUNTAIN OIL AND  
GAS ASSOCIATION, AND WESTERN OIL  
AND GAS ASSOCIATION**

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AND GAS ASSOCIATION**

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The American Petroleum Institute, the Kansas Independent Oil and Gas Association, the Mid-Continent Oil and Gas Association, the Rocky Mountain Oil and Gas Association, and the Western Oil and Gas Association submit this brief as *amici curiae* in support of the petitions for writs of certiorari in Nos. 83-1234, 83-1248, 83-1250, and 83-1278.<sup>1</sup> The petitions seek review of two separate judgments of the Supreme Court of the State of Kansas. That Court held in both cases that, under leases containing "market value" royalty clauses, natural gas producers must pay royalties to Kansas landowners based on an imputed value of the gas that substantially exceeds the maximum price the producers were permitted to charge under federal law.

*Amici* believe that both judgments are incompatible with the uniform and comprehensive federal scheme of natural gas price regulation and are barred by the Supremacy Clause. The petitions present recurring questions of substantial public importance warranting plenary review by this Court.

#### INTERESTS OF THE *AMICI CURIAE*

Each of the *amici* is a petroleum industry trade association whose members include producers of natural gas. Those members are affected either directly or indirectly by the Kansas decisions imposing increased royalty obligations on natural gas producers under "market value" royalty clauses. They therefore have a vital interest in the issues presented by the petitions for certiorari in these cases.

The American Petroleum Institute ("API") represents approximately 315 member companies and 8,000 individual members. API's members are engaged in all facets of the petroleum industry, including the production and

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<sup>1</sup> All parties have consented in writing to the filing of this brief. Copies of letters from counsel have been lodged with the Clerk.

marketing of natural gas throughout the United States, in both interstate and intrastate commerce. API represents the interests of its members before government agencies, in Congress, and in the courts. It appears frequently as a party or as *amicus curiae* in cases affecting the petroleum industry, including cases in this Court.

The Kansas Independent Oil and Gas Association was formed in 1938 to serve the interests of independent oil and gas producers and supporting industries in Kansas. It has approximately 1,300 members. The Association has previously appeared as *amicus curiae* on behalf of its members in court cases involving industry-wide issues.

The Mid-Continent Oil and Gas Association is a voluntary, unincorporated organization of approximately 7,200 individuals devoted to advancing the oil and gas industry in Oklahoma, Kansas, Texas, Louisiana, Mississippi, and Alabama. The Association and its four divisions are concerned with legislative and regulatory matters of interest to the industry on both federal and state levels. It disseminates information to its members and represents the industry before legislative bodies, government agencies, and courts.

The Rocky Mountain Oil and Gas Association was founded in 1920 and today represents approximately 650 companies doing business in Colorado, Idaho, Montana, Nebraska, North Dakota, South Dakota, Utah, and Wyoming. The Association promotes the development, production, and marketing of oil and gas in the Rocky Mountain region. It appears as a party or as *amicus curiae* on behalf of its members in court cases involving issues of importance to the petroleum industry.

The Western Oil and Gas Association represents nearly 100 member companies that conduct much of the production, refining, and marketing of petroleum and petroleum products in the western United States. The Association's purpose is to promote and foster through cooperative

effort the interests of all branches of the western oil and gas industry. It participates frequently as a party or as *amicus curiae* in litigation affecting the interests of its members.

### ARGUMENT

The Ashland, Mobil, and Cities Service petitions involve claims by Kansas landowners seeking additional royalties from natural gas producers for gas sold in the federally regulated interstate market between 1961 and 1978. The leases required the producers to pay fractional royalties based on the "market value" of the gas sold. Although the producers could not lawfully sell the gas at a price higher than the maximum permitted by the Federal Power Commission (and its successor, the Federal Energy Regulatory Commission) under the Natural Gas Act, the Kansas Supreme Court held that the applicable federal ceiling price "is not an obstacle to the fixing of a higher rate as the 'market value' . . . for the purpose of computing royalties." Ashland Pet. App. 13a.

The Kewanee petition involves similar claims for additional royalties for gas sold in the intrastate market between 1978 and 1981, a period during which such sales were subject to federal ceiling prices imposed under the Natural Gas Policy Act. In that case, too, the Kansas Supreme Court held that "royalty owners with a market value lease are not limited to the regulated price." Kewanee Pet. App. 12a. The Court ruled that the producer must pay royalties based not on the highest price it could lawfully charge for the category of gas it sold, but on the highest price paid during the relevant period for any category of natural gas sold in the producing area. *Id.* at 7a-8a, 11a-12a.

1. The Kansas rulings impermissibly invade the exclusively federal domain of natural gas price regulation. Congress "impose[d] a comprehensive regulatory system on the transportation, production, and sale" of natural

gas. *FPC v. Transcontinental Gas Pipe Line Corp.*, 365 U.S. 1, 28 (1961). Where "Congress has so plainly occupied the regulatory field," any state action that creates a "danger of interference with the federal regulatory scheme" "must be declared a nullity." *Northern Natural Gas Co. v. State Corporation Comm'n*, 372 U.S. 84, 92, 93 (1963). The Kansas decisions at issue here present more than a "danger" of interference; they unavoidably clash with the federal rate scheme. The rulings are therefore invalid under the Supremacy Clause because they "stan[d] as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress." *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941).

The "fundamental purpose" of natural gas regulation "is to assure an adequate and reliable supply of gas at reasonable prices." *California v. Southland Royalty Co.*, 436 U.S. 519, 523 (1978). Supply and price, of course, are inextricably linked. In establishing maximum producer rates for interstate sales, the FPC accordingly followed a cost-based approach but included non-cost elements designed "to encourage the production of appropriate supplies of natural gas." *Permian Basin Area Rate Cases*, 390 U.S. 747, 796 (1968); see also *Mobil Oil Corp. v. FPC*, 417 U.S. 283, 320 (1974). The resulting rate structure was thus intended to provide a fair return to producers and an incentive for "satisfactory programs of exploration, development and production." *Permian Basin*, 390 U.S. at 796.

Royalty costs were a significant component of the FPC's rate determinations. For the producing area involved here, the Commission included in its rate calculation a royalty cost factor of 14 percent of the ceiling prices. See *Area Rate Proceeding (Hugoton-Anadarko Area)*, 44 F.P.C. 761, 904, 908 (1970), *aff'd sub nom. In re Hugoton-Anadarko Area Rate Case*, 466 F.2d 974 (9th Cir. 1972). The Kansas Supreme Court ruled, however, that royalties must be paid on the basis of a ficti-

tious market value for the gas far in excess of the applicable ceiling prices. The effect of its decisions is to impose massive retroactive increases in producer royalty costs that amount, for example, to approximately 60 percent of the federal ceiling prices for interstate sales instead of the 14 percent that the FPC had assumed. See *Ashland Pet.* 15; *Mobil Pet.* 8 & n.12; *Cities Service Pet.* 7.

The Kansas decisions will consequently disrupt the federal rate scheme and interfere with fulfillment of the Congressional purposes. The burden of increased royalty payments to Kansas landowners will have to be borne either by the producers themselves or by natural gas consumers. Neither result is consistent with the federally established rate structure. If producers are forced to absorb the costs, they will suffer a reduced rate of return, below that found to be reasonable by the FPC and FERC. They will also have fewer funds for investment in "programs of exploration, development and production" (*Permian Basin*, 390 U.S. at 796), contrary to the Commission's supply objectives. Alternatively, if the FERC were to grant rate relief to the producers, as the Kansas Supreme Court invited it to do (*Ashland Pet.* App. 16a-20a), then the cost of the increased royalty payments would be shouldered by natural gas consumers, contrary to the Commission's price objectives. Indeed, since reduced supply leads over time to increased price, consumers will bear the long-term consequences of the Kansas decisions regardless of how the short-term costs are allocated.

The circumstances here are analogous to those in *Arkansas Louisiana Gas Co. v. Hall*, 453 U.S. 571 (1981) ("*Arkla*"), where this Court invalidated a Louisiana state court award of damages in a breach of contract action brought by a natural gas producer against a pipeline customer. The pipeline had failed to pay a higher price called for under a contingency clause of the con-

tract, and the court awarded damages measured by the difference between the price actually paid and the price that should have been paid. Although both prices were below the applicable federal ceiling, only the lower price had been filed by the producer with the FPC. Under the "filed rate doctrine," a producer may not collect a rate higher than that filed with the Commission.

This Court rejected the producer's claim that "[n]o federal interests" were implicated by an award of contractual damages under state law. *Id.* at 579. It held that the state court had in effect retroactively "award[ed] as damages a rate never filed with the Commission and thus never found to be reasonable within the meaning of the Act." *Id.* The state court judgment consequently "undermine[d] the congressional scheme of uniform rate regulation" and "usurped a function that Congress has assigned to a federal regulatory body." *Id.* at 579, 582. The Court agreed with the Commission that "permitting this damages award could have an 'unsettling effect . . . on other gas purchase transactions' and would have a 'potential for disruption of natural gas markets . . . .'" *Id.* at 579.

The principles of *Arkla* apply with even greater force to this case. Although the Kansas rulings do not directly alter producer rates retroactively, their indirect effect is no less pernicious. The imposition of tens of millions of dollars in increased royalty costs for producers nullifies the cost assumptions underlying the federal rate structure and, as we have shown, unavoidably subverts that structure. Either the supply objective or the price component, or both, will be compromised. Unlike the situation in *Arkla*, moreover, the state court decisions here will affect not merely the "filed rate" but the maximum lawful price. The result here thus holds far greater "'potential for disruption of natural gas markets'" and even more clearly "undermine[s] the congressional scheme of uniform rate regulation." *Id.* at 579.

These principles hold no less in the context of the Natural Gas Policy Act than in that of the Natural Gas Act, under which *Arkla* was decided. Although the price ceilings established by Congress in the NGPA are not strictly cost-based, *Public Service Comm'n v. Mid-Louisiana Gas Co.*, 103 S. Ct. 3024, 3032 (1983), they are deemed "just and reasonable," as were the Commission-set Natural Gas Act rates. *Id.* at 3033; NGPA § 601 (b) (1) (A), 15 U.S.C. § 3431(b) (1) (A). The NGPA's elaborate structure of price ceilings represents a Congressional balancing of producer supply incentives and consumer cost protection. *See Note, Legislative History of the Natural Gas Policy Act: Title I*, 59 Tex. L. Rev. 101 (1980). The Kansas court's disregard of the applicable federal ceiling price in royalty determinations upsets the legislative balance under the NGPA just as it disturbs the rate structure under the predecessor Natural Gas Act.

That the royalty clause rulings operate indirectly rather than directly does not insulate them from the Supremacy Clause. As this Court held when Kansas once before ventured too far, "[t]he federal regulatory scheme leaves no room either for direct state regulation of the prices of interstate wholesales of natural gas, . . . or for state regulations which would indirectly achieve the same result." *Northern Natural Gas Co. v. State Corporation Comm'n*, 372 U.S. at 91.

Nor can the Kansas Supreme Court's action here escape scrutiny under the Supremacy Clause on the theory that the Court merely applied state contract law. Private parties are not "free to make arrangements that would circumvent the ratemaking and supply goals of the statute," *California v. Southland Royalty Co.*, 436 U.S. at 526, and state courts are not free to fabricate or enforce such arrangements by resort to principles of state law. "A regulatory statute such as the Natural Gas Act

would be hamstrung if it were tied down to technical concepts of local law." *United Gas Improvement Co. v. Continental Oil Co.*, 381 U.S. 392, 400 (1965). Thus, as in *Arkla*, "the mere fact that respondents brought this suit under state law would not rescue it, for when Congress has established an exclusive form of regulation, 'there can be no divided authority over interstate commerce.'" 453 U.S. at 580.

It is no answer to say, as the Kansas Supreme Court implied, that the royalty clause rulings can be harmonized with federal objectives if the FERC allows appropriate rate adjustments for affected producers. "Not the federal but the state regulation must be subordinated, when Congress has so plainly occupied the regulatory field." *Northern Natural Gas Co. v. State Corporation Comm'n*, 372 U.S. at 93. "The FERC need not adjust its ruling to accommodate" a state law; "[t]o the contrary, the State may not trespass on the authority of the federal agency." *Maryland v. Louisiana*, 451 U.S. 725, 751 (1981).

2. Kansas is the only State that has imputed a market value for royalty purposes in excess of the federal ceiling price for regulated gas. As each of the petitions for certiorari points out, the United States Court of Appeals for the Fifth Circuit and the highest courts of Texas, Louisiana, Arkansas, and Oklahoma, in applying "market value" royalty clauses, have all properly avoided a conflict with the overriding federal scheme of natural gas price regulation. See *Ashland Pet.* 13-14; *Mobil Pet.* 19-20; *Cities Service Pet.* 14-15; *Kewanee Pet.* 16-17.

The decisions here, if allowed to stand, will therefore have anomalous consequences. A producer operating in both Kansas and a neighboring State under leases containing identical royalty clauses will nevertheless be required to pay dramatically higher royalties to Kansas landowners than to those in the sister State for sales of gas in the same federal price category. Producers in Kansas, moreover, may be competitively disadvantaged

in comparison with similarly situated producers in Texas or Oklahoma who are not burdened by increased royalty obligations. Consumers may be forced to pay a higher price for gas produced in Kansas than for gas produced in another State, merely because of the differing state court holdings on "market value" royalty clauses. Finally, the FERC will have to consider making geographically discrete rate relief adjustments to accommodate the unique royalty determinations of the Kansas Supreme Court.

These results are at war with the FPC's and FERC's efforts "to achieve the uniformity of regulation which was an objective of the Natural Gas Act." *Northern Natural Gas Co. v. State Corporation Comm'n*, 372 U.S. at 91-92. If the Kansas decisions are left undisturbed, "the scope of federal regulatory power would vary in accordance with the kaleidoscopic variations of local contract law" (*id.* at 98), a result plainly foreclosed by the Supremacy Clause.

3. The questions presented here are of substantial national importance. Kansas is the Nation's fifth largest gas producing State. See Energy Information Administration, *Producer Revenues, Prices, and Concentration in the Natural Gas Market* 11 (Nov. 1983). Gas produced in Kansas is sold to major pipelines serving customers in the mid-continent, the upper midwest, and elsewhere. The supply and price consequences of the Kansas Supreme Court's decisions will therefore be felt far beyond the Kansas borders.

"Market value" royalty clauses, moreover, are commonly found in mineral leases in all areas of the country, and litigation over the application of such clauses has been going on in most of the gas producing States for more than a decade. Although the courts in most of the States had determined that "market value" is limited by the applicable federal ceiling price (or by the price re-

ceived under the producer's contracts with its customers), the Kansas decisions, if left in place, may ignite a fresh round of judicial or legislative efforts to secure for the landowners in other States the benefits provided to Kansas landowners by the Kansas Supreme Court. The issues therefore have continuing importance for producers, pipeline companies, and natural gas consumers nationwide.

The Kansas rulings puncture a large hole in the fabric of federal natural gas regulation. They seriously impair the capacity of the FERC to assure uniform and effective regulation of the price and supply of natural gas. Whether a state court may apply "market value" royalty clauses in this manner without invalidly encroaching upon the federal regulatory jurisdiction warrants this Court's plenary consideration.

### CONCLUSION

The petitions for writs of certiorari should be granted.

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